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February 13, 1997

VIA FEDERAL EXPRESS

Office of the Secretary
Federal Communications Commission
1919 M Street, N.W., Room 222
Washington DC 20554

Re: In the Matter of Access Charge Reform
Docket No.: 96-262

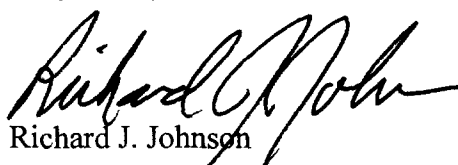
Dear Secretary:

Enclosed for filing are an original and sixteen (16) copies of the Reply Comments of the Minnesota Independent Coalition on the Access Charge Reform.

Also enclosed for submission is a diskette containing the above-mentioned Reply Comments. The diskette has been formatted pursuant to the instructions in the Notice of Proposed Rulemaking.

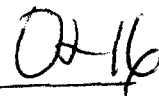
If you should have any questions regarding the enclosures or other issues with respect to the filing submitted on behalf of the Minnesota Independent Coalition please feel free to contact the undersigned.

Very truly yours,


Richard J. Johnson

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Enclosures
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BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION

WASHINGTON, D.C. 20554

In the Matter of)	
)	
Access Charge Reform)	CC Docket No. 96-262
)	
Price Cap Performance Review for Local Exchange Carriers)	CC Docket No. 94-1
)	
Transport Rate Structure and Pricing)	CC Docket No. 91-213
)	
Usage of the Public Switched Network by Information Service and Internet Access Providers)	CC Docket No. 96-263
)	
)	

**REPLY COMMENTS OF THE
MINNESOTA INDEPENDENT COALITION**

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Date: February 14, 1997

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and Internet Access Providers)	
)	

**REPLY COMMENTS OF THE
MINNESOTA INDEPENDENT COALITION**

The following Reply Comments are submitted by the Minnesota Independent Coalition ("Minn. Indpt. Coal."), an unincorporated association of over 80 Local Exchange Carriers ("LECs") providing telephone exchange service and exchange access service to over 260,000 access lines in Minnesota. All members of the Minn. Indpt. Coal. are "rural telephone companies."¹

¹ See, 47 U.S.C. § 153(47).

I. LECS MUST BE PERMITTED TO RECOVER THE DIFFERENCE BETWEEN PRUDENTLY INCURRED EMBEDDED COSTS AND FORWARD-LOOKING ECONOMIC COSTS.

The NPRM raises several questions related generally to whether special allowance should be made for recovery of “embedded” or “stranded” historical costs that will not be recovered under the proposed pricing methodology.² Some parties have argued that it is not necessary to allow such recovery.³ To the contrary, for the reasons set forth below, it is necessary to allow recovery of prudently incurred embedded costs. Failure to do so will result in unconstitutional “taking” of LEC property without just compensation.

A. It Is Well Established That Inadequate Utility Rates May Violate the Compensation Clause of the Fifth Amendment.

The takings clause of the Fifth Amendment “is designed not to limit the governmental interference with property rights per se, but rather to secure compensation in the event of otherwise proper interference amounting to a taking.” First English Evangelical Lutheran Church v. County of Los Angeles, 482 U.S. 304, 315 (1987). Clearly, the setting of utility rates may involve a “taking” if the prescribed rates are inadequate. FCC v Florida Power Corp., 480 U.S. 245, 253 (1987); Duquesne Light Co. v. Barasch, 488 U.S. 299, 307, 109 S.Ct. 609, 615 (1989); Permian Basin Area Rate Cases, 390 U.S. 747, 770, 88 S.Ct. 1344, 1361 (1968). A just and reasonable rate must be “sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and attract capital;” and the rate should also be “commensurate with returns on investments in other enterprises having similar risks.” F.P.C. v. Hope Natural Gas Co., 320 U.S. 591, 603, 64 S.Ct. 281, 288 (1944).

² See, Notice of Proposed Rulemaking, FCC 96-488, CC 96-262, December 24, 1996 (“NPRM”) ¶¶ 249-255.

³ See, e.g. Comments of MCI Communications Corporation (“MCI Comments”) at pp. 30-34; Comments of State Consumer Advocates (“State Advocate Comments”) at pp. 56-60.

A method of setting rates that deprives a regulated entity of the opportunity to recover its prudent investments cannot pass constitutional muster. Brooks -Scanlan Co. v. Railroad Commission, 251 U.S. 396, 399 (1920). As Justice Scalia explained in Duquesne Light Co. v. Barasch, 488 U.S. 299, 317 (1989), the Constitution requires that a utility be allowed a “fair return on investment,” and as part of any method used to set rates, there must be a measure of the “investment” against which returns may be judged to be “fair.” As discussed further below, the investment by which that judgment is made is the embedded prudent investment of the incumbent local exchange carrier (“ILEC”).

B. Adoption of A New Pricing Theory That Excludes Recovery of Substantial Embedded Investments Would Violate the Fifth Amendment.

Some parties misconstrue the holding in Duquesne, *supra*, as a grant of broad discretion to exclude prudently incurred historical costs from recovery when setting rates.⁴ To the contrary, the Duquesne Court strongly indicated that, had it been asked to address the consequences of the challenged methodology, it would have been required to consider the impact of the decision in relation to the utility’s prudently incurred investments.

In Duquesne, the court denied the utilities request to recover certain historic costs. But the utility’s challenge in Duquesne was, in effect, limited to “techniques” rather than “consequences.” Duquesne, 488 U.S. at 317 (Scalia, J., concurring). The Court pointedly observed that “[n]o argument has been made that the slightly reduced rates jeopardized the financial integrity of [Duquesne], either by leaving [it] insufficient operating capital or impeding [its] ability to raise future capital,” (emphasis added) or that the rates were “inadequate to compensate current equity holders for the risk associated with their investments under a modified

⁴ See, State Advocate Comments at p. 57.

prudent investment scheme.” Duquesne, 488 U.S. at 312. The Court acknowledged, however, that because regulated utilities depend on the rate methodology to ensure a fair return, “. . . a state’s decision to arbitrarily switch back and forth between methodologies in a way which required investors to bear the risk of bad investments at some times while denying them the benefit of good investments at others would raise serious constitutional questions.” *Id.* at 315. Further, had the consequences of such a rate adjustment been more severe, the significance of the prudent investments would quite probably have been different. As Justice Scalia noted:

[W]hile ‘prudent investment’ (by which I mean capital *reasonably expended* to meet the utility’s legal obligation to assure adequate service) need not be taken into account as such in rate making formulas, *it may need to be taken into account is assessing the constitutionality of the particular consequences* produced by those formulas. We cannot determine whether the payments a utility has been allowed to collect constitute a fair return on investment, and thus whether the government’s action is confiscatory, unless we agree upon what the relevant ‘investment’ is. *For that purpose, all prudently incurred investments may well have to be counted.* . . . That question has *not been presented* in the present suit, which challenges techniques rather than consequences.

(Emphasis added.) Duquesne, *supra*. 488 U.S. at 317 (Scalia, J. concurring).

C. Uncertain Possibilities to Earn Additional Revenues Are Inapplicable to Small LECs And Are Inadequate to Satisfy Constitutional Requirements.

Both MCI and the State consumer Advocates argue that, as a result of deregulation, the LECs will have “new opportunities . . . to use their interstate facilities to provide new services and gain new sources of revenue,” and/or “expanded business opportunities associated with competition.”⁵ This assertion is insufficient to sustain a radical reduction in access revenues for small ILECs for two reasons.

⁵ See, MCI Comments at p. 31-32; State Advocate Comments at p. 58.

First, vague possibilities of expanded business opportunities do not meet the requirements of the Fifth Amendment. Second, small LECs do not have comparable “new” opportunities to the interLATA market that may become available to the Regional Bell Operating Companies (“RBOCs”) under the Act.⁶

The Court has said that a rate-setting method that excludes some historical cost could be countenanced by the Constitution, but only if it is “compensated by countervailing factors in some other aspect.” Duquesne, supra. 488 U.S. at 314. However, every rate order must be balanced within its own four corners - i.e., an agency cannot simply promise to make up a deficiency in some future proceeding. FMC v. Hope Natural Gas, 320 U.S. 591, 602 (1944). Mere possibilities of additional revenues from other sources at some uncertain future time are inadequate. The Commission must establish a method within its Order in this proceeding that provides the reasonable opportunity for recovery of prudent investments that is required by the Constitution.

Further, the Act provides far greater new opportunities for RBOCs than for small ILECs. Other parties’ references to “new opportunities . . . to use their interstate facilities” are clearly addressed to the interLATA long distance services that RBOCs may become eligible to provide.⁷ Such opportunities provide no quid pro quo for small ILECs, who face no current legal impediment to providing interLATA services and who are thus not provided new opportunities by the Act.

Further, any “new opportunities” for small ILECs to compete as CLECs would be largely unrelated to use of the small ILECs existing interstate access facilities in their serving areas.

⁶ See, Section 271.

⁷ Id.

Seizing “new opportunities” available as CLECs will require new investment by the small LECs that relate to services that may be provided in other areas. It is well settled that a utility cannot be compelled to incur losses in regulated businesses based on profits from other businesses of the same firm.⁸

D. The LECs Unrecovered “Embedded” Costs Are Substantial and Are The Result Of Regulatory Action.

MCI and the State Consumer Advocates contend that the ILEC’s unrecovered “embedded” costs should not be considered as part of a “fair return” on investment because they have lost economic value due to technological change or the effects of competition.⁹ This argument must be rejected because it ignores the regulatory context in which the ILECs’ investments were initially made and substantially maintained as capitalized assets.

ILECs operate in a capital intensive business, with much of their networks represented by long lived, slowly depreciating investments in “embedded” plant. The TELRIC pricing methodology is not intended to provide for the recovery of the existing investments, but instead is intended to provide recovery of the costs of a hypothetical “most efficient network.” The result, in many cases, will be revenues substantially lower than at current levels,¹⁰ which will effectively confiscate from the ILECs and their investors the value of their “prudently incurred investments.”¹¹

In addition, when adopting a substantial change to its access charge pricing methodology, the FCC is operating in a context. The Commission has acknowledged that “. . . some incumbent

⁸ Brooks-Scanlan, supra 251 U.S. at 399; Norfolk and Western Ry. Co. v. Connolly, 236 U.S. 605, 609 (1915).

⁹ See, MCI Comments at p. 32; State Advocates Comments at p. 58.

¹⁰ NPRM at ¶ 248.

¹¹ Duquesne, 488 U.S. at 317 (Scalia, J. concurring).

LECs may have incurred certain embedded costs reasonably before the passage of the 1996 Act, based on different regulatory regimes.”¹² That is certainly correct.

The ILECs have for years been subject to state and federal regulatory system designed to provide a return based on historical costs. The ILECs have been and remain under a regulatory obligation to provide service to all in a community who desire such service, including both end users and IXCs. In fulfillment of that duty, and in reasonable anticipation of future requests for increased service, the ILECs have made large, long-term investments in highly specialized, immovable facilities. The regulatory context was intended to provide incentives and credible assurances for the ILECs to undertake the substantial capital investments required to perform their service obligations. As part of that regulatory system, states and the FCC have carefully controlled the rate at which ILECs can depreciate and recover those capital investments.¹³ The impact is particularly clear for small LECs, which have remained under rate-of-return regulation by the Commission. 47 C.F.R. § 69.3. As a result, many ILECs have enormous under-depreciated capital accounts reflecting amounts the ILECs have not yet been permitted to recover, -- amounts that due to the depreciation schedules chosen by regulators, might often exceed the current value of the assets.

Access charges constitute a very substantial source for recovery of these investments. For Minnesota Independent Coalition members. Interstate access charges provide revenues per access line per month ranging from \$12.00 to over \$50.00.¹⁴ While there is no inherent Constitutional obstacle to the adoption of a new theory for establishing access prices (as parties

¹² Implementation of the Local Competition Provisions in The Telecommunications Act of 1996, First Report and Order, CC Docket No. 96-98, 11 FCC Rcd 15499 (1996) at ¶ 707.

¹³ See, Minn. Stats. 237.22 and 47 U.S.C. § 152, 47 C.F.R. §§ 32.2000, 43.43, part 69.

¹⁴ Minnesota Independent Coalition Comments at pp. 3-4.

have stated), the constitutionality of any specific theory will be evaluated based on its "result".¹⁵ Even a compelling theory will not suffice if the result is elimination of revenues essential to the recovery of prudent investments.

Given this regulatory context, it would be totally inappropriate to impose on ILEC shareholders the losses resulting from under-depreciation that resulted from the Commission and state regulatory agency decisions. Under the Fifth Amendment, the ILEC shareholders cannot legally be required to incur the costs of a dramatic shift in rate setting method and rationale.¹⁶

E. Conclusion.

For these reasons, the Commission should reject the arguments of parties that deny a constitutional obligation to allow a reasonable opportunity for recovery of investments.

Dated: February 14, 1997.

Respectfully submitted,

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¹⁵ See, Hope, *supra*, 320 U.S. at 602.

¹⁶ See, Sidak and Spulber, "Deregulatory Takings and Breach of the Regulatory Contract," 71 N.Y.U.L. Rev. 851 (Oct. 1996).